Dissenting Views to Accompany
H.R.1956, the "The Business Activity Tax Simplification Act of 2005"

We strongly oppose H.R. 1956, the "Business Activity Tax Simplification Act of 2005," which would impose a federal physical presence standard for determining when a state can impose a business activity tax. While proponents of H.R. 1956 maintain that federal legislation is needed to clarify the nexus standard for state business activity taxes to minimize litigation, this legislation is more likely to have the opposite effect. In fact, if H.R. 1956 were enacted, it would legalize certain tax sheltering practices and income shifting methods. This legislation is strongly opposed by the National Governors Association, the National Association of Counties, and the National School Boards Association and the Center on Budget and Policy Priorities.[1]

H.R. 1956 is problematic for several reasons. First, the proposed legislation would severely limit the ability of state and local governments to levy their corporate income and similar taxes on multistate corporations which are earning income within the state but lack a permanent or physical presence there. Second, while proponents claims that H.R. 1956 will minimize litigation, in fact, the legislation would create reorganization opportunities that could provide new ground for litigation. Third, the legislation that is likely to result from the "physical presence" standard established by H.R. 1956, would have a significant impact on the state revenue creating an issue of federalism and result in an unfunded mandate.

Description of the Legislation

HR. 1956, introduced by Rep. Goodlatte in April 2005, would establish "physical presence" as the nexus standard for levying state and local business activity taxes on interstate commerce. Specifically, this legislation would preempt state law to provide that an out-of-state company must have a physical presence in a state before the state can impose franchise taxes, business license taxes, and other business activity taxes. The physical presence threshold is the minimum amount of activity a business must conduct in a particular state to become subject to taxation in that state.

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[1]Letter from Governor Mike Huckabee, Chairman of the National Governors Association and Governor Janet Napolitano, Vice Chair of the National Governors Association to Representative Sensenbrenner, Chairman of the House Judiciary Committee and Representative Conyers, Ranking Member of the House Judiciary Committee (March 19, 2006)(on file with the House of Representative Committee on the Judiciary, Democratic Staff). Letter from Larry Naake, Executive Direction of the National Association of Counties to Representative Sensenbrenner, Chairman of the House Judiciary Committee and Representative Conyers, Ranking Member of the House Judiciary Committee (March 28, 2006) (on file with the House of Representative Committee on the Judiciary, Democratic Staff). Letter from Michael A. Resnick, Associate Executive Director, National School Boards Association to Representative Sensenbrenner, Chairman of the House Judiciary Committee (June 27, 2006) (on file with the House of Representative Committee on the Judiciary, Democratic Staff). Electronic letter from Martha Coven, Senior Legislative Associate, Center on Budge and Policy Priorities (June 20, 2006) (on file with the House of Representative Committee on the Judiciary, Democratic Staff).

H.R. 1956 would also amend P.L. 86-272, which limits the power of states to impose net income taxes on interstate commerce. Under this legislation, P.L. 86-272 would apply to services and intangible property of all in state businesses. In addition, H.R. 1956 would generally require use of employees of services for more than 21 days per calendar year in a state to establish nexus. These regulations would exacerbate underlying inefficiencies because the nexus threshold for businesses- the 21 day rule, which is higher than currently exists in most states- would increase the opportunities for businesses to manipulate their activities to avoid paying state taxes. Finally, H.R. 1956 would enumerate exempt activities, allowing certain tax shelters or income shifting methods that a number of states consider questionable.

Background

Generally, both in-state and out-of-state businesses that are "doing business" in a state, pay corporate income taxes (business activity taxes or BAT) on the money earned in that state. These taxes may only be imposed on those businesses that have a "substantial nexus" with the state. A state may, therefore, tax a transaction if there is an appropriate level of connection of the transaction to the state. BAT taxes differ from the obligation to collect sales or use taxes imposed on non-resident businesses. Both, however, are governed by the Constitution.

The Due Process[2] and Commerce Clauses[3] of the U.S. Constitution limit a State from imposing tax liability or collection responsibilities on a business unless there is a substantial nexus with the state.[4] Thus, the issue of when a state has the authority to impose a tax upon an non-resident corporation depends upon whether that corporation has sufficient connection with the state to warrant the tax obligation. In *Quill Corp. v. North Dakota,*[5] the Supreme Court set out a bright-line test of "physical presence" to satisfy the necessary connection with a state under the dormant commerce clause but explicitly limited that test to the duty of mail order houses to collect use taxes from customers. The *Quill* Court did not, however, clearly address the question whether "physical presence" is required to impose other types of taxes on non-resident businesses, including BAT, or under what standard.[6]

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[2]U.S. Const. Amend. XIV § 1.

[3]U.S. Const. Art. I § 1 8, cl. 3.

[4]Generally, the Due Process Clause relates tot he fairness of the tax burden and whether a business has sufficient contacts with the taxing jurisdiction to justify the tax. The Commerce Clause is concerned with the effect of the tax on interstate commerce. *See* Walter Hellerstein, Supreme Court Says No Use Tax Imposed on Mail-order Sellers . . . for Now, 77 J. Tax'n 120, 120 (Aug,. 1992)

[5]504 U.S. 298 (1992).

[6]Business interests argue that the Quill standard should apply to all taxes, while states have employed an apportionment standard that is based on what is referred to as "economic nexus." The Supreme Court has refused to clarify whether "economic nexus" is sufficient under the Constitution. In *Geoffrey, Inc. v. South Carolina Tax Commission*, 313 S. C. 15, 437 S.E.2d 13, *cert. denied*, 510 U.S. 992 1993), for example, the Supreme Court denied certiorari in a case in which the South Carolina Supreme Court found sufficient connection between a Delaware

I. H.R. 1956 limits the ability of state and local governments to levy their corporate taxes on out-of-state companies.

Under current law, both in-state and non-resident businesses that are doing business in a state may be subject to business activity taxes on income earned in that state. Each state independently implements rules for economic activities - which are not covered by P.L. 86-272 - that establish nexus. State rules are very similar for most services and activities.

The "physical presence" standard adopted by the bill favors businesses with limited physical presence but often with major economic activity within the state, while shifting the state corporate income tax burden to small businesses, manufacturing, and natural resource and service industries - businesses that create jobs, pay local property taxes, and sponsor little league teams. Furthermore, out-of-state businesses often benefit substantially from public services provided by the states such as roads and police protection. In addition, these companies benefit from states in which they have no physical presence but do have customers and can reasonably be expected to pay some amount of business activity tax. For example, when an out-of-state bank makes mortgage loans in a state, the value of the houses that serve as collateral depends on the quality of local schools and the safety of the community. Furthermore, that same out of state bank would use the local court system is used if legal action necessary for non payment of loans. Each of these services is provided by the state, notwithstanding a company's physical presence in that state.

The adoption of a physical presence standard will also permit the creation of tax shelters for non-resident businesses and discriminate against traditional "brick and mortar" companies within the state. A Congressional Research Service analysis of H.R. 1956 concludes:

> The new regulations as proposed in H.R. 1956 would have exacerbated underlying inefficiencies because the threshold for business - the 21-day rule, higher than currently exists in most states - would increase opportunities for tax planning leading to more "nowhere income." In addition, expanding the number of transactions that are covered by P.L. 86-272 also expands the opportunities for tax planning and thus tax avoidance and possibly evasion.[7]

Finally, in an increasingly borderless economy, taxing authorities argue that a bright line standard is outdated, inappropriate, and would impede, rather than promote economic growth by encouraging business entities to evade their tax responsibilities.

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corporation and the state of South Carolina to justify a business activity tax. The Delaware corporation's contact with the state consisted of intangible property.

[7] *See* Congressional Research Service Report for Congress, RL32297, *State Corporate Income Taxes: A Description and Analysis* (March 23, 2004). (A copy is on file with the House of Representative Committee on the Judiciary, Democratic Staff).

II. Although proponents claim that H.R. 1956 could mitigate litigation, it is more likely to provide new ground for litigation.

The proponents state that the legislation is needed to correct the trend of federal and state court decisions which strongly imply that "physical presence" is the nexus needed to levy business activity tax under the Constitution. Specifically, they claim that H.R. 1956 would establish a clear physical-presence nexus standard that would reduce the amount of litigation that is occurring. Instead, the legislation contains numerous undefined terms and confusing provisions that would no doubt spark litigation in the quest to ascertain what Congress meant. In H.R. 1956, physical presence is described as, "Using the services of an agent (excluding an employee) to establish or maintain the market in the State, if such agent does not perform business in the State for any other person during such taxable year," with no explanation or interpretation of its meaning.[8] Among other things, the bill fails to elaborate on the meaning of such critical terms as "services," "establish or maintain," "market," or "perform business."

Additionally, the legislation is likely to spawn costly litigation by allowing new opportunities for businesses to reorganize in order to avoid taxes. The bill is drafted to limit physical presence to "collectively and on more than 21 days in the aggregate, during such person's taxable year," and to excluded those who are conducting, "activities in connection with a possible or an actual purchase of goods or services for consumption by the person's business."[9] This construction will likely spur corporations to shelter their profits from taxation by changing their business practices so that they fall within the guidelines of the legislation. In reaction, the states will be forced to use alternative means to enforce the state taxation laws. Further, many states have discretionary authority to treat in-state and out-of-state subsidiaries for tax purposes as if they are one corporation. To protect their revenues, the states are more likely to use this authority, creating addition litigation.

III. H.R. 1956 reduces states tax revenue affecting the states ability to provide traditional state and local government services and is an unfunded mandate

As a policy matter we would note that State and local governments work with the federal government, both providing essential government services like education and transportation. However, states are restricted from providing these services if their power of taxation is truncated or interfered with. Furthermore, it will be state officials and not Congress who will be held accountable if public services are reduced or personal income or property taxes are increased to compensate for the reduction in tax revenue resulting from the enaction of this legislation.

H.R. 1956 would also create an enormous unfunded mandated resulting in a several billion dollar loss for state revenues.[10] According to a survey conducted by the National Governors Association, the business activity tax proposal would cost states more than several

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[8] H.R. 1996, Section 3(b)(2).

[9] H.R. 1956, Section 3.

[10] According to the CBO, "While virtually all states would lose revenues, about 70 percent of the estimated losses would come from ten states: California, Florida, Illinois, Michigan, New Jersey, New York, Pennsylvania, Tennessee, Texas, and Washington."

billion annually. As state governments, unlike the federal government, are required to balance their budget, the lost of such a significant amount of revenue must be replaced by either increasing taxes or cutting programs. The Congressional Budget Office Cost estimates that the cost of this bill to state and local government would exceed $1 billion the first full year after enactment and would likely grow to approximately $3 billion annually in 2011. Thus, these costs would exceed the threshold under UMRA for intergovernmental mandates by $64 million in 2006.

Conclusion

H.R. 1956 is ill-considered legislation that would provide unnecessary tax exemptions resulting in a huge revenue loss to states. In an era when our states are in desperate need of revenue for the protection of our citizens, it seems irresponsible that should we enact legislation that would reduce their funds.

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